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# Declaratory Rulings, A Brief Sketch of a Possible Administrative System Offered

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11

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# *The* **TAX MAGAZINE**

April

1938

*In this Issue*

**Declaratory Rulings**

**The Co-ordination of Federal, State  
and Local Taxation**

**Priorities and Lien Preferences Accorded  
Federal and State Claims in Cor-  
porate Reorganizations**

**Immunities from the Income Tax**

**Problems of Homestead Tax Exemption**



# *The* TAX MAGAZINE

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The editorial policy is to allow frank discussion of tax issues. On this basis contributions are invited. The editors will exercise care in checking on the accuracy of data printed, but responsibility is not assumed for the contents of the articles or for the opinions of which expression is allowed.

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## *Contents for* **APRIL, 1938**

**Vol. 16**

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*General:*

PAGE

Declaratory Rulings.....	Roger J. Traynor	195
The Co-ordination of Federal, State and Local Taxation.....	Marvel Stockwell	198
Priorities and Lien Preferences Accorded Federal and State Claims in Corporate Reorganizations.....	Harry L. Logan, Jr.	201
Immunities from the Income Tax.....	Emmett L. Bennett	207
Problems of Homestead Tax Exemption.....	E. B. Schmidt	211
Digests of Articles on Taxation in Current Legal Periodicals...		219
Pending State Tax Legislation.....		222
Federal Tax Calendar.....		226
State Tax Calendar.....		227
The Revenue Bill of 1938.....		231
Tax Return Troubles.....		231
Branch of Bureau of Internal Revenue Established at Los Angeles.		235
Recent Personnel Changes within the Bureau of Internal Revenue.		235
1938 Conference of the National Tax Association to Meet in Detroit		235
Principal Changes in 1937 Income Tax Forms.....		236
Taxes on Industry in 15 States.....		237
Stock Rights Received in Reorganization.....		237
Tax Evasion.....		237
<i>Talking Shop with Lewis Gluck</i> .....		216
<i>Current Books of Interest in the Field of Taxation</i> .....		249
<i>Rulings of the Bureau of Internal Revenue</i> .....		251
<i>Court Decisions</i> .....		252
<i>Significant Decisions of the Board of Tax Appeals</i> .....		255

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## Declaratory Rulings\*



### A brief sketch of a possible administrative system offered

By **ROGER J.  
TRAYNOR\*\***

SOME years ago the Bureau of Internal Revenue issued rulings on situations in advance but its unsystematic procedure in this regard led to serious administrative difficulties. The source of the difficulties lay in the unreliability of the rulings, dramatically illustrated in the well-known *Cousens* case. Largely to avoid a recurrence of such experiences the Bureau arrived at its present policy not to issue a ruling with respect to a transaction that has not been completed.<sup>1</sup>

While remedying one situation this policy has aggravated another by failing to provide an administrative method of removing tax uncertainties attendant upon contemplated transactions. Cognizant of this situation the Subcommittee of the House Ways and Means Committee observes in its report that:

"\* \* \* the Commissioner of Internal Revenue, while having ample authority to make administrative rulings, has no authority to make rulings which will be binding on both the Government and the taxpayer with respect to transactions and facts which have not yet been entered into or computed, or transactions with respect to which the taxable year relating thereto has not been closed. Taxpayers cannot now obtain authoritative guidance in the resolution of doubts concerning matters of this type. As a result business transactions are often delayed or abandoned because of tax uncertainties. Just as often they are entered into under a mistaken notion of the tax liabilities involved, and when liabilities unforeseen by the taxpayer ensue, he feels

compelled to litigate in defense of the position he has taken. Such litigation is the natural aftermath of uncertainties and erroneous interpretations which could largely be avoided if authoritative administrative guidance were available prior to the completion of the transaction."

The Subcommittee therefore recommends that:

"appropriate statutory provisions be prepared giving to the Commissioner of Internal Revenue discretionary authority to make declaratory rulings." (Recommendation 49.)

This recommendation is of immediate practical interest for if carried into effect it would liberalize the present practice and permit rulings with respect to contemplated transactions.

It should be emphasized at the outset that such a change would have to be made with the greatest care. A layman is likely to become impatient with the Bureau's unwillingness to give him the advice he desires in connection with pending business transactions which may involve tax liability. An informed professional audience, adept at proposing perplexing questions, knows only too well that the Bureau must plot its course with cautious restraint. To begin with, the possibility of declaratory rulings might be so exploited by taxpayers and other interested persons as to absorb most of the Bureau's energies. Business men contemplating a certain reorganization but doubtful as to the most economical procedure from a tax point of view might put case after variant case, asking a declaratory ruling on each. A tax service might exercise the ingenuity of its staff in composing questions which would be easier to ask than to answer.

### Rulings Issued at Commissioner's Discretion

PLAINLY the Commissioner should have free discretion to give or decline declaratory rulings and at the same time should be in a position to insist upon coöperation from applicants for rulings. It would of course be essential that the Commissioner exercise his discretion reasonably and systematically. With capable administration it is not likely that responsibility would be shunned or important issues dodged. Even so, as in any phase of government, there are bound to be unpleasant episodes when persons consider themselves aggrieved because they are denied informative assistance. The solution of these problems lies as much with the tax bar as it does with the Commissioner.

As a background for the discussion of the problems involved in declaratory rulings, it may be helpful to sketch briefly a possible administrative system for the issuance of such rulings: The taxpayer would present to the Commissioner his application

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<sup>1</sup> Mim. 4589, 1937-1 C. B. 536.

for a declaratory ruling, prepared in accordance with regulations established by the Commissioner. The Commissioner would then examine the application to ascertain whether the subject matter warranted consideration. If he found that it would be desirable to issue a declaratory ruling he would then proceed to consider whether he had sufficient information upon which to act. If the application were defective in this regard, he could either request the taxpayer to supply additional information or could himself make any investigation that he deemed appropriate, subject to the same limitations now existing with respect to the investigation of closed cases. The Commissioner could of course refuse to issue the ruling where the information obtained proved inadequate. Prior to the issuance of the ruling, the taxpayer could if he wished appear in person to present any considerations he deemed relevant. Other taxpayers not represented in the application, but who face similar problems and to whom the ruling might apply, would be given a similar opportunity. On the completion of these preliminary steps, the Commissioner would then issue the declaratory ruling. He might also issue rulings on his own motion, and presumably would do so when he believed that administration of the revenue laws would be facilitated by authoritative declarations on doubtful points.

### Important Elements of Declaratory Rulings

A DECLARATORY ruling would enumerate and specify in detail the persons, taxes, taxable years and transactions to which it applied and any other terms and conditions which the Commissioner found necessary to provide. Copies of the declaratory ruling would be made available to any persons interested.

Once issued, the effect of the declaratory ruling would depend upon completion of the transaction in accordance with the terms of the ruling. If the question of compliance were involved in any later proceeding, the burden would fall upon the taxpayer to prove the requisite compliance. A taxpayer who wished to make certain that he had complied with the terms of the ruling might apply for a second declaratory ruling on the matter of compliance. If such a second ruling were issued it would be binding upon both parties because of the mutual consent involved, the taxpayer having requested confirmation of compliance, and the Commissioner having found such compliance. A ruling would not become effective in the event the taxpayer deemed it inadvisable to consummate the transaction in view of the tax liabilities indicated by the ruling.

### Steps Preliminary to Issuance of Rulings

THE steps preliminary to the issuance of declaratory rulings raise such questions as always accompany the development of any administrative project. Experimentation and practice would play their part in developing an effective machinery.

Once a ruling has been issued and complied with, a more serious problem would arise as to how far it would bind the Commissioner on the one hand and the taxpayers on the other. Cutting across these problems would be the inter-relation between these administrative interpretations and those of the courts in determining tax controversies.

Most declaratory rulings would probably relate to transactions affecting the tax liability of a single taxpayer for a single year. Clearly a ruling of this kind should be binding upon the Commissioner if the taxpayer consummated the transaction in compliance with the terms and conditions of the ruling. Naturally there need be no provision for appeal to the courts by the Commissioner from his own ruling; nor should the taxpayer be permitted to question the ruling in the courts prior to its becoming effective. Courts are sufficiently burdened with actual litigation to deserve freedom from moot cases. Until consummation the transaction could not form the basis even of a declaratory judgment. When a ruling has become effective, however, the taxpayer should be free to test its validity in the same way he is now free to contest a regulation. Obviously the mere application for a declaratory ruling should not operate as a blanket consent to be bound by whatever ruling the Commissioner may issue. But if the taxpayer chose to contest the validity of a declaratory ruling in a Board or court proceeding, the Commissioner as well as the taxpayer should be free to proceed as if there had been no ruling, for the ruling could hardly be binding on the Commissioner when the taxpayer chose not to be bound by it.

While provision might well be made for conditioning the effectiveness of some types of declaratory rulings upon written consent of the taxpayer, a categorical requirement that such consent be prerequisite to binding effect upon the Commissioner would impart an undesirable rigidity to the system. In addition, it would seem contrary to a realistic approach to tax laws. The Government prepares these laws to raise revenue. Those who are required to pay this revenue would seem entitled to know how much they must pay. In an earlier day this could be accomplished by the tax laws themselves; dealing with simple and direct taxes, they could be written simply. Every tax lawyer realizes that the income tax laws of today could not feasibly be written for the layman or even the general legal practitioner. Consequently the responsibility of Government to inform the citizen of the tax bill that he owes devolves upon the agency charged with the administration of the tax laws. Recognition of the duty to provide advice requires recognition of the correlative right of the taxpayer to rely upon the advice given to him. If he did not wish to be bound by that advice he should be free to present his own views before appropriate tribunals. If he chose to accept it, however, the Government should stand by it. The binding effect upon the Government of its own advice should not thus be made dependent upon the taxpayer's waiving at the outset his privilege to dispute it.



## Rulings Applicable to More than One Taxpayer or Taxable Year

NEW problems arise when the ruling applies to a transaction covering more than one taxable year or applies to more than one taxpayer. In the former case the Commissioner might well insist that the taxpayer be prevented from playing hare and hounds with the ruling by following it in the years in which it proves advantageous and contesting it in those in which it proves disadvantageous. In the interests of certainty and reduction of litigation, it might be well to restrict the taxpayer's right to contest a continuing declaratory ruling to the earliest taxable year regarding which a challenge can be made. Such a contest, if successful, should control all previous taxable years not barred by the statute of limitations. Again the ruling should not be binding upon the Commissioner where the taxpayer chose not to follow it in its entirety. These restrictions would in effect be a compromise between the alternative of conditioning the binding effect on the Commissioner upon the written consent of the taxpayer to be bound himself and the alternative of permitting the taxpayer to contest the ruling at any time, with its attendant possibilities of utilization of the ruling as a device to avoid taxes. It seems fair that the taxpayer should be bound once he has signified his acceptance of the ruling after a reasonable time within which to contest it.

While declaratory rulings, unlike regulations, would deal with specific transactions, and consequently would generally apply to single taxpayers, many of them would necessarily affect several persons because of their common relation to a transaction—the parties to a trust or partnership agreement, the stockholders of a corporation, etc. If one of these persons successfully contested the ruling it would seem advisable to treat all uniformly by providing that the ruling shall be ineffective for the future as to all. Moreover, in order to eliminate multiplicity of suits, a procedure might be afforded whereby the court having jurisdiction of the proceeding in which the ruling was contested, on motion of the Commissioner or of the other persons to whom the ruling applied, might order such persons to be made parties to the proceeding. In view of the common relation of such persons to the transaction and the desirability of having any decision affecting the ruling operate as uniformly as possible, the decision should be applied retroactively to all such persons to the extent permitted by the statute of limitations.

## Rulings Co-ordinated with General Scheme of Tax Law

THE above discussion has considered only the direct relations between the Commissioner and the taxpayer to whom a ruling applies. Declaratory rulings must also be coördinated with the general scheme of tax law. It would seem clear that a system of declaratory rulings should not interfere with the uniform application of future tax legislation. A declaratory ruling inconsistent with a later amend-

ment or addition to the internal revenue laws should cease to be effective. Different considerations obtain in the case of a judicial decision contrary to a declaratory ruling. As noted earlier, if the decision related to a proceeding in which the declaratory ruling were directly in issue, the ruling would be subordinated in the future to the decision, so that a decision holding a declaratory ruling invalid would render it ineffective for the future. There may, however, be instances where the declaratory ruling itself would not be involved but the issues in the judicial proceeding would be such that a decision on them would indicate whether the interpretation embodied in the ruling were proper. If an independent body of declaratory rulings reaching far into the future were permitted to exist side by side with inconsistent judicial decisions, there would result a deplorable lack of uniformity. On the other hand there will be instances where the arguments for certainty outweigh those for uniformity, so that the declaratory ruling should continue as the rule of law for the persons to whom it applies. The doctrine of *res adjudicata*, the finality of closing agreements and compromises, the application of regulations without retroactive effect under section 506 of the 1934 Act, the statute of limitations, are all instances of a similar preference for certainty as opposed to uniformity. In order to provide effectively for all of the varying situations that might arise, the Commissioner should be free to limit the ruling to specified taxable years. This limitation would provide an essential safeguard where uniformity in the law is the first consideration, and at the same time permit the Commissioner to deal adequately with those situations where a fixed and definite rule is required.

## Conclusion

IN CONCLUSION I should like to speak briefly of a proposal distinct from the project for declaratory rulings but having a natural connection therewith. Among the most pressing problems in the administration of the revenue laws is the determination of the time when securities become worthless or a deduction becomes allowable for bad debts. Where many taxpayers are involved it is immaterial in the long run which year is determined upon inasmuch as the net effect of placing the deduction in one or another of the possible years is approximately the same. It nevertheless remains highly important that a determination uniformly applicable to all taxpayers concerned be obtained as expeditiously as possible. This could be made possible by providing for declaratory rulings to cover such cases, to be issued after public hearings were held upon due notice to all interested parties. Rulings of this particular type would contain findings of fact, made by the Commissioner upon the basis of the written record obtained at these hearings, which would be final if supported by evidence. Such a procedure would insure an effective administrative determination of these questions and its uniform application to all the taxpayers involved.